INDEX

CITATIONS

IN THE

Supreme Court of the United States

OCTOBER TERM, 1964

No. 134

PARAGON JEWEL COAL COMPANY, INC., *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

---

BRIEF OF JEWELL RIDGE COAL CORPORATION IN SUPPORT OF PETITIONER

Jewell Ridge Coal Corporation, with written consent of all parties to the case, which consents are on file with the clerk, respectfully presents this brief on the merits in support of petitioner.

INTEREST OF AMICUS CURIAE

Petitioner Paragon Jewel Coal Company's position in the present case is similar to that of Jewell Ridge Coal Corporation in *Commissioner v. Raymond E. Cooper, et al.*, No. 262, this Term, decided by the court below on the same day (330 F. 2d 163). The Commissioner's petition for writ of certiorari in No. 262 was not granted pending decision in the present case. We understand that the Commissioner will take no further action to obtain a writ in No. 262, but instead will ask that it be disposed of in accord with the outcome here.

For reasons argued in their respective briefs, the Commissioner and Paragon are in agreement that the present case and No. 262 were wrongly decided by the Court of Appeals and that both should be reversed. Jewell Ridge agrees with the Commissioner's and Paragon's positions, but in our view the decisions of the Court of Appeals, here and in No. 262, were wrong for fundamental and important reasons which, we understand, will nevertheless not be argued in either the Commissioner's or Paragon's brief, but which are set forth in this brief.

Jewell Ridge also believes that two or more essential facts in No. 262 make it an even stronger case for the Commissioner's position than this one, so that if the present case is reversed No. 262 should be also. If the present case is affirmed the Commissioner's petition in No. 262 should be granted for consideration of the additional arguments, also fundamental and important, which are available to the Commissioner in that case. One of those arguments, mentioned only collaterally in the Commissioner's brief in No. 262 before the court below, is that there was an express understanding between Jewell Ridge and its contract mine operators

that Jewell Ridge could, as it did, maintain complete, unilateral control over the amount of coal which its contract mine operators were from time to time permitted to mine. The Commissioner nevertheless took the position below that the question and the governing legal principles were substantially the same in No. 262 as in the present case, and the court below disposed of No. 262 on the basis of its decision in the present case. For the reasons mentioned, such action should be taken here only if the present case is reversed.

SUMMARY OF ARGUMENT

I. The depletion deduction is a return of capital to the owner of a wasting asset for the part used in production. The owner's cost of his capital interest is unimportant, as is the legal form of his ownership. But the claimant's legally enforceable rights must constitute ownership, the resulting economic right must be a capital interest and that interest must be in the wasting asset, the mineral deposit in the ground. A claimant's right to depletion can, therefore, be tested by inquiring whether, as a matter of substance, without regard to mere formalities, his legally enforceable rights are equivalent to ownership of an undivided legal interest in the mineral in place, which in this case was coal.

A. One such right is legal control. An owner of capital invariably has, at some point in time, complete legal control of his capital, i.e., an economic right capable of realization as gross income solely by the exercise of his enforceable legal rights in the mineral deposit. But in this case, even if the contract mine operator's contract was non-terminable (which is in dispute), his only legal rights were to perform the

service of extracting and delivering the coal and, presumably, so long as he performed satisfactorily, to prevent production of the coal without his participation. These two rights, taken separately or together, do not constitute ownership of a capital interest in a mineral deposit, since an exclusive contract to perform services is not a capital interest and since a right to prevent production without one's participation falls short of complete legal control of capital.

B. Another such right, closely associated with the first, is the possibility of profit. As an owner of capital, the holder of a depletable interest has a legally enforceable right to a share in the value of the mineral deposit. But in the present case there was no direct or indirect contractual or other legal linkage between the value of the coal extracted and the amount to which the operators were entitled. If the operators' costs of labor went down, or the leaseholder's costs of production increased, the leaseholder (Paragon) could decrease the amount paid operators, even though the price of coal remained stable. Or if the price of coal increased Paragon might keep nearly all the increase or pass along most of it to the operators, depending on the relative bargaining positions of the parties at the time. The contract mine operator did not have a fixed or determinable right to share in the value of the mineral deposit, and hence his right to payment was not depletable.

C. A third characteristic of ownership of a wasting capital asset is that the owner's income is dependent solely on the mineral extracted from the deposit in which he has an interest. If his income can come from another source it is not depletable. In this case, however, the contract mine operator's income was not dependent solely on the mineral extracted from the de-

posit in which he claimed an interest. Each operator received the same amount per ton, without regard to the quality of the coal he mined, and insofar as amounts paid an operator came from coal, the source was all the coal mined from Paragon's leasehold, not the coal he mined. Consequently the interest claimed was not a depletable one.

II. That the operator made an investment is neutral in determining whether the legal right in which he invested was the ownership of a capital interest. Since the analysis summarized above shows that the operators' contracts lacked at least three essential attributes of a depletable interest and were, in essence, agreements to perform services for pay under a piecework method of compensation, the operators' investments were in their employment contracts, not in the coal in place.

ARGUMENT

Under principles declared by this Court in *Palmer* v. *Bender*, 287 U.S. 551, 557, and applied by every subsequent decision of this Court, a taxpayer is entitled to depletion where he has: (1) acquired, by investment, any interest in the mineral in place and (2) secured, by legal relationship, income derived from the extraction of the mineral, to which he must look for a return of his capital. *Parsons* v. *Smith*, 359 U.S. 215, 221. The Court of Appeals purported to find these two requisites in what it thought were the contract mine operator's non-terminable rights, under his contract, (a) to mine the coal under a specific surface area to exhaustion and (b) to be paid therefor at a price which was closely related to the market price (R. 254-255). In so doing, the court below misconceived the principles laid down by this Court, as will now be shown.

I. The Contractor Did Not Acquire, By Investment, Any Capital Interest in the Coal in Place

In the case of mines and other natural deposits, sections 611(a) and 613(b)(4) of the Internal Revenue Code of 1954 ("Code") permitted for the years here involved, as a deduction from gross income, "a reasonable allowance for depletion" which, in the case of coal, was limited to ten percent "of the gross income from [mining][1] the property". Section 614(a) of the Code defined the term "property" as "each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land."

The purpose of the depletion deduction and the content of the term "interest" has been spelled out in decisions by this Court. "[T]he deduction is to be regarded as a return of capital, not as a special bonus for enterprise and willingness to assume risks. * * * In essence, the deduction for depletion does not differ from the deduction for depreciation" (*United States* v. *Ludey*, 274 U.S. 295, 303). "The deduction is permitted * * * in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production. The granting of an arbitrary deduction * * * of a percentage of gross income was in the interest of convenience and in no way altered the fundamental theory of the allowance" (*Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 366-367).

---

[1] Section 613(c) provided that "the term 'gross income from the property' means the gross income from mining" and that " 'mining' includes not merely the extraction of the ore from the ground, but also the ordinary treatment processes normally applied by mine owners or operators to obtain the commercially marketable mineral product" including (in the case of coal) "cleaning, breaking, sizing, dust allaying, treating to prevent freezing, and loading for shipment."

"While there are income incidents to the utilization of natural resources, there is also an obvious exhaustion of the capital used to produce the income. In theory the aggregate sum allowed for depletion would equal the value of the natural resource at the time of its acquisition by the taxpayer, so that at the exhaustion of the resource the taxpayer would have recovered through depletion exactly his investment. The administrative difficulties in taxation of oil and gas production in view of the uncertainties of quantities and time of acquisition, that is at the purchase of the property or at the discovery of oil or gas, finally have brought Congress to the arbitrary allowance of 27½ per cent[2] now embodied in § 114(b)(3).[3] Thus, the 27½ per cent is appropriated by the statute to the restoration of the taxpayer's capital and the rest of the proceeds of the natural asset becomes gross income. It follows from this theory that only a taxpayer with an economic interest in the asset, here the oil, is entitled to the depletion" (*Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. 599, 602-603, footnotes added). "In short, the purpose of the depletion deduction is to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset" (*Parsons* v. *Smith,* 359 U.S. 215, 220).

"It is true that the right to the depletion allowance does not depend upon 'any particular form of legal interest in the mineral content of the land' " (*Helvering* v. *Bankline Oil Co.,* 303 U.S. 362, 367). The decisions of this Court have rested upon "practical consequences", and not "upon the particular instrument involved, or upon the formalities of the conveyancer's

[2] Ten per cent for coal.

[3] Predecessor of Code § 613(b)(1).

art" (*Anderson* v. *Helvering,* 310 U.S. 404, 411). But "[t]echnical title to the property depleted would ordinarily be required for the application of depletion or depreciation" (*Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, 33), and "ownership" of an interest in the mineral is "essential" (*Thomas* v. *Perkins,* 301 U.S. 655, 661).

In *Lynch* v. *Alworth-Stephens Co.,* 267 U.S. 364, involving oil and gas leases which (p. 369) "did not convey title to the unextracted ore deposits", the "interest" which was "property" and hence depletable was "the exclusive possession of the deposits and the valuable right of removing and reducing the ore to ownership." These very same legal rights were described in *Palmer* v. *Bender,* 287 U.S. 551, as (p. 557) "legal control of a valuable economic interest in the ore capable of realization as gross income by the exercise of his mining rights under the lease" and as (p. 558) "complete legal control of the oil in place".

Helvering v. *Bankline Oil Co.,* 303 U.S. 362, in which a gas processor who had not acquired complete legal control of the gas in place was denied a depletion deduction, distinguished between a depletable "economic interest" in the mineral deposit and a non-depletable "economic advantage" through contractual relation to the owner, as follows (pp. 367-368):

> "But the phrase 'economic interest' is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit.
>
> * * * *
>
> "Undoubtedly, respondent through its contracts obtained an economic advantage from the produc-

tion of the gas, but that is not sufficient. The controlling fact is that respondent had no interest in the gas in place. Respondent had no capital investment in the mineral deposit which suffered depletion and is not entitled to the statutory allowance."

Helvering v. *O'Donnell*, 303 U.S. 370, drew the same distinction where an owner of one-third the stock in a corporation had no "interest" in a mineral deposit owned by the corporation, and did not acquire such an interest by contracting to sell his shares for a price measured by the purchaser's net profits from exploitation of the deposit (which the purchaser agreed to acquire), the Court stating (p. 372):

> "As consideration for his stock in the San Gabriel Company respondent bargained for and obtained an economic advantage from the [purchaser's] operations but that advantage or profit did not constitute a depletable interest in the oil and gas in place."

An owner of "interests" in a mineral deposit, who transferred these for an amount payable either from minerals produced out of the deposit or from sale of fee title to the very same land, did not retain such an "interest", that is "a capital investment in the oil and gas in place", since the payments (which actually were made entirely from oil so produced) were "not dependent entirely upon the production of oil" and might under the contract "be derived from sales of the fee title to the land conveyed" (*Anderson* v. *Helvering*, 310 U.S. 404, 407, 412). The Court stated (p. 413):

> "In the interests of a workable rule, [prior cases] must not be extended beyond the situation in which, as a matter of substance, without regard to

formalities of conveyancing, the reserved payments are to be derived solely from the production of oil and gas."

Kirby Petroleum Co. v. *Commissioner,* 326 U.S. 599, involved a fee simple owner of land who leased it for the production of oil and gas in consideration for a cash bonus, a royalty in usual form and a share of the net profits realized by the lessees from their operations under the lease. Referring (p. 606) to the taxpayer in *O'Donnell* as "a stranger to the lease" and to *Anderson* v. *Helvering* as having "correctly stated that a share in 'net profits', disassociated from an economic interest, does not entitle the holder to a depletion allowance", the Court held (p. 604):

> "If the additional payment in these leases had been a portion of the gross receipts from the sale of the oil extracted by the lessees instead of a portion of the net profits, there would have been no doubt as to the economic interest of the lessors in such oil. This would be an oil royalty. The lessors' economic interest in the oil is no less when their right is to share a net profit. As in *Thomas* v. *Perkins,* 301 U.S. 655, their only source of payment is from the net profit which the oil produces. In both situations the lessors' possibility of return depends upon oil extraction and ends with the exhaustion of the supply. Economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil."

Burton-Sutton Oil Co. v. *Commissioner,* 328 U.S. 25, differed from *Kirby* in that the depletion claimant, in consideration for transferring his legal control of the oil deposit to another, retained 50 percent of the net proceeds from the oil deposit but no accompanying

royalty. The Court again held the assignee-assignor taxpayer entitled to depletion, stating (p. 33):

"Since lessors as well as lessees and other transferees of the right to exploit the land for oil may retain for themselves through their control over the exploitation of the land valuable benefits arising from and dependent upon the extraction of the oil, Congress provided * * * for equitable apportionment of the depletion allowance between them to correct what was said to be an existing inequality in the law or its administration.

"In the present case, the assignor of the petitioner before assignment had an economic interest in the oil in place through its control over extraction. Under the contract with petitioner, its assignor retained a part of this interest—fifty per cent of net. Like the other holders of such economic interest through royalties, the petitioner looked to the special depletion allowance of § 114 (b)(3) to return whatever capital investment it had. The cost of that investment to the beneficiary of the depletion under § 114(b)(3) is unimportant. Depletion depends only on production. It is the lessor's, lessee's or transferee's 'possibility of profit' from the use of his rights over production, 'dependent solely upon the extraction and sale of the oil,' which marks an economic interest in the oil."

Commissioner v. *Southwest Exploration Co.*, 350 U.S. 308, dealt with an upland owner who exchanged the use of his property for contract rights to control production from an oil deposit and 24½% of the net proceeds from the deposit. The Court recited the two requisites for an economic interest from *Palmer* v. *Bender*, stating as to the second factor (p. 314):

"The second factor has been interpreted to mean that the taxpayer must look *solely* to the ex-

traction of oil or gas for a return of his capital, and depletion has been denied where the payments were not dependent on production, *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372, or where payments might have been made from a sale of any part of the fee interest as well as from production. *Anderson* v. *Helvering*, 310 U.S. 404. It is not seriously disputed here that this requirement has been met. The problem revolves around the requirement of an interest in the oil in place" (italics in original).

Finally, *Parsons* v. *Smith*, 359 U.S. 215, dealt with a contract coal miner whose contractual relationship with the owner of the coal deposit was, in essence, the performance of services for pay under a piecework method of compensation. The Court refused to find that the contract miner had, in effect, exchanged his agreement to perform services for a depletable capital interest in the coal in place, stating (p. 224, 226):

> "* * * petitioners simply agreed to provide the equipment and do the work required to strip mine coal from designated lands of the landowners and to deliver the coal to the latter at stated points, and in full consideration for performance of that undertaking the landowners were to pay to petitioners a fixed sum per ton. Surely those agreements do not show or suggest that petitioners actually made any capital investment in the coal in place, or that the landowners were to or actually did in any way surrender to petitioners any part of their capital interest in the coal in place. Petitioners do not factually assert otherwise. Their claim to the contrary is based wholly upon an asserted legal fiction. As stated, they claim that their contractual right to mine coal from the designated lands and the use of their equipment, organizations and skills in doing so, should be regarded as the making of a

capital investment in, and the acquisition of an economic interest in the coal in place. * * *

* * * *

"Of course, the parties might have provided in their contracts that petitioners would have some capital interest in the coal in place, but they did not do so—apparently by design. Instead, petitioners simply entered into contracts, terminable without cause on short notice, with the owners of coal-bearing lands to provide the equipment and do the work required to strip mine and deliver coal from those lands, as independent contractors, for fixed unit prices."

The foregoing distillation of cases from *Ludey* through *Parsons* demonstrates that this Court's decisions are all consistent in spelling out the essential requisites of a depletable interest in the light of the statute's constant purpose. The depletion deduction is a return of capital to the owner of a wasting asset for the part used in production. The owner's cost of his capital interest is unimportant, as is the legal form of his ownership. But ownership and capital it must be. Hence entitlement to the deduction is to be tested by determining whether, as a matter of substance, without regard to mere formalities, the taxpayer's legally enforceable rights are equivalent to ownership of an undivided legal interest in the mineral deposit in place.

One such right is legal control. An owner of capital invariably has, at some point in time, complete legal control of his capital. The owner of a depletable interest must likewise acquire complete legal control of a valuable economic right capable of realization as gross income solely by the exercise of his enforceable legal rights in the mineral deposit. Another such right,

closely associated with the first, is the possibility of profit. As an owner of capital, the holder of a depletable interest has a legally enforceable right to a share in the value of the mineral deposit. A third characteristic of ownership of a wasting capital asset is that the owner's income from production is dependent solely on exhaustion of the mineral deposit in which he has an interest, so that if his income can come from another source it is not depletable.

These three characteristics, although not necessarily the minimum requisites nor exclusive tests, are essential and must be found in every depletable interest. On the other hand, compensation for services is not depletable, so that in every case where a taxpayer claims to have exchanged his agreement to perform services for a depletable capital interest in a mineral deposit, the rights of the parties must be examined closely to see whether such an exchange of services for property can be deemed to have occurred.

A. THE COAL AT ALL TIMES, EVEN AFTER IT WAS MINED, BELONGED SOLELY TO PARAGON.

Here, as in *Parsons*, a basic difficulty faced by the contract mine operators is that their contracts were, in essence, to perform services for pay, and provide incidental equipment and facilities to do the work, under a piecework method of compensation, measured by the number of tons of coal mined and delivered to the owner. Compensation for services is non-depletable ordinary income. Hence the operators necessarily must contend that the pay they received was not for the services they performed. This they do by contending that they, in effect, exchanged their agreements to perform services for a "capital interest" in the coal in place, which they then transferred back to the owner,

reserving a "possibility of profit" from that capital interest "dependent solely upon the extraction and sale" of the coal. A pertinent inquiry, then, is whether such a constructive exchange of services for property should be deemed to have occurred in this case.

The Court of Appeals throught that in this case there was such an exchange, even though it apparently would convert ordinary income into a tax-free return of capital. The appellate court also thought that *Parsons* was distinguishable, since there the contract miner's rights to extract and deliver coal were terminable[4] by the owner without cause on short notice, whereas in the present case the Court of Appeals believed that each contract mine operator had a right to mine the coal under a specific surface area to exhauston.[5] But even if such a right existed (a matter disputed by both Paragon and the Government), the right was not a depletable interest, as shown by the following analysis.

It is plain that unless and until the coal was mined by the operators they did not own a single ton. If they quit, as they were entitled to do, they could not transfer their rights to another, nor could they take any coal

---

[4] Under the first (P-22) of six Huss contracts in *Parsons* v. *Smith*, the coal deposit owner had only "the right to temporarily suspend work under this contract at any time or times by giving Contractor written notice". If the suspension continued for a period of five weeks, Contractor had only the right to elect to terminate the contract (contract provision printed 150 F. Supp. 224, 229, fn. 7). The Government's brief treated this contract (P-22) as, in effect, terminable at will by the owner (Nos. 218 and 305, Oct. Term, 1958, Respondent's brief, p. 11, fn. 7). Cf. GCM 26290, 1950-1 CB 42, 46 (next to last paragraph); *Mammoth Coal Co.*, 22 T.C. 571, 576, rev'd on this point 229 F. 2d 535, 538 (CA 3), cert. den'd 352 U.S. 824.

[5] The Tax Court found that the operator's right to mine in an area was non-exclusive (R. 223, lines 12-30), while the Court of Appeals said nothing on the point. Cf. *Denise Coal Co.* v. *Commissioner*, 271 F. 2d 930, 933 (CA 3).

with them. They had only the right, personal to them, to mine the coal in a specific area to exhaustion. Similarly, when and as the coal was mined, it belonged solely to Paragon, and the operators could not sell or keep any of it, but were required to deliver all that they mined to Paragon. Hence the only legal rights which an operator had were (1) to perform the service of extracting and delivering the coal and (2) presumably,[6] so long as he performed satisfactorily, to prevent production of the coal without his participation.

It should be plain that these two rights, taken separately or together, do not constitute ownership of an interest in the mineral deposit. An exclusive contract to perform services is just that and nothing more. Similarly a right to prevent production from a mineral deposit without one's participation is not equivalent to ownership of an interest in the mineral deposit. In *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, where a gasoline extractor had invested in (p. 365) "necessary pipe lines and connections from casingheads or traps at the mouth of the well to its plant" and had acquired a contract right (p. 367) "to a delivery of the gas produced at the wells", the Court held that the extractor's right to prevent production without his participation was (p. 368) "no interest in the gas in place". That decision was sound, since one whose rights in a mineral deposit are limited to either participating in or preventing production has not "acquired legal control of a valuable economic interest capable of realization as gross income by the exercise of his mining rights".[7]

[6] See footnote 5, *supra*.

[7] *Palmer* v. *Bender*, 287 U.S. 551, 557.

Such a person has no "'possibility of profit' from the use of his rights over production".[8] Rather, in common with any person who has a monopoly of machinery necessary for extraction, or of transportation necessary to carry the mineral from mine to processing plant, or of surface rights necessary for extraction or haulage, unless and until one holding such a monopoly exchanges it for "complete legal control of the [mineral] in place"[9] he has no "ownership" of an "interest" in the mineral deposit. *Commissioner* v. *Southwest Exploration Co.,* 350 U.S. 308, is not to the contrary, since there the upland owners, in exchange for (p. 316)"the use of their land", acquired both an "agreement with [Southwest] setting forth in detail the procedures to be followed by Southwest in conducting operations from the uplands'"[10] and a contract right to (p. 309) "24½% of the net profits" from the oil deposits. Thus the upland owners in *Southwest Exploration* acquired what the contract mine operators in the present case lacked, namely "ownership" of an "interest" in the mineral deposit. Here as in *Parsons* v. *Smith* the contract miners did not acquire legal control of the coal deposit and hence they had no depletable capital interest in the coal in place.

---

[8] *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, 34.

[9] *Palmer* v. *Bender,* supra, at 558.

[10] Par. 14, U.S. Court of Claims Findings of Fact, 132 F. Supp. 718, 725. The contract rights acquired by the upland owners included rights to control "the surface location and subsurface course of [Southwest's] wells, * * * the location of all surface facilities, the quality of all equipment to be used by [Southwest] in connection with such facilities and the manner of performing all drilling and other operations by [Southwest]" (Findings Par. 27, 132 F. Supp. 718, 727).

B. THE CONTRACTOR DID NOT ACQUIRE THE REQUISITE POSSIBILITY OF PROFIT DEPENDENT SOLELY UPON EXTRACTION OF THE COAL.

There is another and an equally serious difficulty across the contract mine operator's path in the present case. In *Parsons* v. *Smith* the operator's piecework rate of compensation was fixed,[11] whereas here it was not fixed. Rather, prospective price changes were made by Paragon[12] at will,[13] the contractors were notified several days in advance of any price change,[14] the amount paid by Paragon fluctuated somewhat with extended changes in the market price of coal and changes in labor costs,[15] and there was no evidence that the amount paid by Paragon was directly related either to the price it was getting for the coal or to the sales price of a particular contractor's coal.[16] The Court of Appeals stated that "the operators had a continuing right to produce the coal and to be paid therefor at a price which was closely related to the market price,"[17] but (even if this were true) such price could be changed by Paragon on short notice[18] and, subject to the opera-

[11] The piecework rates under both the Parsons and the Huss contracts were subject to increase sufficient to cover higher labor costs, but were not otherwise subject to change (359 U.S. 215, 217, 218).

[12] R. 214.

[13] R. 222.

[14] R. 214.

[15] R. 222.

[16] *Ibid.*

[17] R. 255.

[18] R. 86, 87, 93, 105, 118-120, 142, 144.

tor's right to quit at any time,[19] the new price could be determined unilaterally by Paragon.[20]

The Tax Court concluded that the amount payable to the contract mine operators was changeable at the will of Paragon,[21] and this was not contradicted by the Court of Appeals.[22] Jewell Ridge agrees, therefore, with the Government's argument in its brief that Paragon's right to set and change the amount paid operators precludes any contention that an operator had a depletable capital interest in the mineral deposit.

But even if the immediately foregoing view were not correct, and even if this Court were to conclude that Paragon did not have an unrestricted right to set and change the amount paid operators, it would not follow that the operators had a depletable interest in the coal in place.

The record is plain that, even though the amount paid by Paragon "was closely related to the market price"[23] in the sense that when times were good Paragon paid more and when times were bad it paid less,[24] there was no agreement that, if the market price of coal increased a specified amount per ton, the amount paid the operator would increase proportionately, nor was there any agreement that, if the market price of

---

[19] R. 255, lines 19-23.

[20] R. 49, 50, 51, 56, 64-65, 86, 87, 90-91, 93, 105, 106, 118-120, 142, 144, 169, 185-186; see also R. 114, 136, 147, 170, 180.

[21] R. 222.

[22] See R. 254, lines 13-15, R. 255, lines 27-29.

[23] R. 255.

[24] R. 96, 118-120, 222, 230, 250.

coal decreased to a specified extent, the amount paid operators would decrease proportionately.[25] Instead it was understood that the amount paid operators could be prospectively increased or decreased by Paragon on short notice[26] and in so doing Paragon was entitled to and did take into account its competitive position in the market place,[27] the amount paid contract mine operators by other coal producers,[28] the costs of operations (both the contractors'[29] and Paragon's[30]), the market price of coal,[31] and possibly other factors.[32] Thus, in February 1952 there was a substantial increase in the amount paid operators[33] even though the market price had not increased for months;[34] there was no decrease in the amount paid operators from February to October, 1952,[35] although the market price fell in that period;[36] and there was a further increase in October, 1952[37] due to an increase

---

[25] Tax Court, R. 222; Testimony, R. 95, 96.

[26] Court of Appeals, R. 254; Tax Court, R. 214; Testimony, R. 86, 87, 93, 105, 118-120, 142, 144.

[27] R. 169, 186; see also R. 45, 50, 51, 56, 114, 119, 120, 136, 147.

[28] R. 50, 102, 143; see also R. 46, 48, 49, 109-110, 133-134, 148.

[29] R. 119, 120, 147, 178; see also R. 116-117, 141.

[30] R. 51, 102, 169.

[31] R. 50, 56, 114, 119-120, 136, 147, 170, 180; but see 65, 94, 95, 96, 128, 141-142, 144.

[32] R. 106, 117, 123; see also R. 50, 56, 67, 90-91.

[33] R. 118, 230.

[34] R. 250.

[35] R. 119, 230.

[36] R. 250.

[37] R. 119, 230.

in the operators' costs of labor.[38] It follows that if the operators' costs of labor went down, or Paragon's costs of production increased, Paragon might decrease the amount paid the operators, even though the market price of coal might have remained stable. Similarly, if the market price of coal increased, Paragon might keep a lion's share of the increase, or it might pass along nearly all the increase to the contract operators, depending upon the relative bargaining position of the parties at the time. In short, there was no direct or indirect contractual or other legal linkage between the value of the coal extracted and the amount to which the operators were entitled.

This Court has never held that such a right to payment constitutes "ownership" of an "interest" in a mineral property; nor should it. As the Court stated in *Palmer* v. *Bender*, 287 U.S. 551, a depletable interest is (p. 557) "legal control of valuable economic interest in the ore capable of realization as gross income by the exercise of his mining rights". Capsulated in *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, 604, "economic interest does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil." Or as rephrased by the Court in *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, 34, "it is the lessor's, lessee's or transferee's 'possibility of profit' from the use of his rights over production, 'dependent solely upon the extraction and sale of the oil', which marks an economic interest in the oil."

As the foregoing decisions show, the economic right which the holder of a depletable interest owns is the

[38] R. 119.

same in substance as that held by the owner of an undivided legal interest in the mineral property itself. The depletable interest may be in the form of a fixed amount for each unit of the mineral produced, or it might be a right to a fraction of each unit extracted, or a right to a portion of either the gross profits or the net profits realized from the mineral. But except where the right is to a fixed amount or fraction, or where a party bearing more than his share of the costs is permitted to recoup his excess costs from the first production, each owner of a depletable interest will share proportionately in profits realized to the extent of his interest. Thus in a case without fixed, temporary or limited payment rights, if the costs of production were to go down while the market value of the mineral remained stable, each owner of a depletable interest would share proportionately in the profits realized. Similarly if the market value of the mineral increased while the costs of production remained stable, each such owner would likewise share proportionately in the profits. And if the costs of production went down while the market value of the mineral increased, each such owner would profit doubly. In sum, the owner of a depletable interest has an enforceable legal right to a fixed or determinable share in the value of the mineral deposit.

In the present case, as has been shown, the contract mine operators had no such right. There was no agreement that the amount paid would remain fixed. Nor was there any agreement as to each party's share of increases or decreases in market price. There was no direct or indirect contractual or other legal linkage between the value of the coal extracted and the amount to which the operators were entitled. The contractor

did not have a fixed or determinable right to share in the value of the mineral deposit, and hence his contract right to payment failed an essential test of a depletable interest.

C. THE CONTRACTOR'S INTEREST, IF ANY, WAS IN PARAGON'S TOTAL OPERATION, NOT IN THE COAL HE MINED.

In the present case, Paragon installed a road running around a mountain close to the outcrop line of the coal, contracting with numerous mine operators to mine and deliver the coal to Paragon's tipple, where Paragon cleaned, sized and sold the coal.[39] The coal as delivered to the tipple was not salable, but had to be washed, graded and treated to be salable.[40] In the process, the coal mined by all the operators was mixed together, the rock, dirt and other extraneous matter was removed, and the coal was washed, sized, graded and oil treated, emerging as four different grades of coal, each of which sold at a different price.[41] The contractor, however, was paid so much a ton, regardless of the quality or market value of the particular coal he mined.[42] Thus, though the amount paid contractors "was closely related to the market price,"[43] in the sense that when times were good Paragon paid more and when times were bad it paid less,[44] the amount paid a contractor was neither fixed nor dependent solely upon either the market value or the sale price

---

[39] Court of Appeals, R. 253-254; Tax Court, R. 211-212.

[40] R. 216.

[41] R. 95, 96.

[42] R. 168, 222.

[43] R. 255.

[44] R. 96, 118-120, 222, 230, 250.

of the coal underlying the "specific surface area"[45] allocated to him. Hence, even if the contractor were deemed to have a profit interest in the coal (which he did not[46]) and even if Paragon's income from coal were deemed the sole source of amounts payable to contractors (which it was not[47]), the source of a contractor's profit was all the coal mined from Paragon's leasehold, not the coal he mined.

This Court frequently has announced that to have a depletable interest the claimant's possibility of profit must be dependent solely upon extraction of the mineral from the deposit in which he claims an interest, and the Court has not allowed depletion in any case except where this was true. In *Anderson* v. *Helvering,* 310 U.S. 404, depletion was denied where the amounts paid actually came out of the minerals produced from the deposit, but where under the contract such amounts might have been derived from sales of fee title to the land containing the deposit. As expressed in *Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. 599, 604: "Economic interest [means] the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil." *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, stated (p. 34): "Depletion depends only upon production. It is the lessor's, lessee's or transferee's 'possibility of profit' from the use of his rights over production, 'dependent solely upon the extraction and sale of the oil' which marks an economic interest in the oil." Thus, in *Commissioner* v. *Southwest Exploration Co.,* 330 U.S. 308, the Court said (p. 314):

> "The second factor has been interpreted to mean that the taxpayer must look *solely* to the extrac-

---

[45] R. 254.

[46] Parts A and B, *supra,* pp. 14-23.

[47] Amounts due contractors were payable from all Paragon's resources, including borrowed and equity capital (R. 216).

> tion of oil or gas for a return of his capital, and depletion has been denied where the payments were not dependent on production [citing Helvering v. Elbe Oil Land Co.], or where payments might have been made from a sale of any part of the fee interest as well as from production [citing Anderson v. Helvering]." (italics in original)

The principle reflected in the mentioned decisions is sound. The purpose of the depletion deduction is to permit the owner of a capital interest in a mineral deposit to make a tax-free recovery of the part used up in production (*Parsons* v. *Smith,* 359 U.S. 215, 220). In theory the aggregate sum allowed for depletion would equal the value of the deposit at the time of its acquisition by the taxpayer, so that at the exhaustion of the resource the taxpayer would have recovered through depletion exactly his investment (*Kirby Petroleum Co.* v. *Commissioner,* 326 U.S. 599, 602-603). In essence, the deduction for depletion does not differ from the deduction for depreciation (*United States* v. *Ludey,* 274 U.S. 295, 303). It follows that, to constitute a depletable interest in a mineral deposit, the owner's return must be entirely dependent upon extraction of the mineral from that deposit, so that none of his return could come from any other source, for otherwise it would be necessary to trace each dollar to its source to be sure that it represented a recovery of the depletable interest (*Anderson* v. *Helvering,* 310 U.S. 404, 413).

In the present case, the contract mine operator's income was not dependent solely upon the mineral extracted from the deposit in which he claimed an interest. The coal underlying his "specific surface area" might have been the lowest quality on Paragon's leasehold. It is inherently improbable that the yield of high and low grade ores would be in exactly the same proportion from each mine; and the record shows that

the characteristics of the coal seam varied sharply from mine to mine, sometimes within short distances.[48] Yet each contract mine operator received the same amount per ton, without regard to the quality of the coal he mined.[49] Thus, to such extent as an operator's income actually came from Paragon's, the amount paid each operator came, in part, out of proceeds from the coal he mined and, in part, out of proceeds from the coal mined by all the other operators. No operator's income was dependent solely on extraction of the coal from the area in which he claimed an interest. Rather the source of an operator's income, insofar as it actually came from coal, was all the coal mined from Paragon's leasehold,[46] and not the coal mined by the operator. Consequently the interest claimed by the contract mine operator was not depletable.

II. The Contractor's Investment Was in His Employment Contract, Not in the Coal in Place

Concededly the contract mine operators invested time and money in their mining operations.[50] The same was true in *Parsons*.[51] It is equally clear that the amount of the operator's investment is unimportant.[52] But the fact that the operator made an investment is entirely neutral in determining whether the legal right in which he invested was the ownership of a capital

---

[48] R. 35 (lines 11-13), 44 (23-34), 49 (24-28), 67 (1-10), 95 (7-14), 101 (10-14), 123 (30-39).

[49] R. 86, 105, 128, 185.

[50] R. 255.

[51] *Parsons* v. *Smith*, 359 U.S. 215, 217, 218, 223-224.

[52] *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25, 34; *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 312.

interest in the coal in place.[53] For if upon analysis the facts further show that the contractual relation in which the operator invested was an economic advantage derived from production, rather than ownership of a capital interest in the coal in place, the operator is not entitled to share in the depletion deduction.[54]

In the present case, analysis discloses that the operators' contracts lacked at least three essential attributes of a depletable interest. First, their contracts were, in essence, to perform services for pay, and provide incidental equipment and facilities to do the work, under a piecework method of compensation. But such contracts, if deemed non-terminable (a matter of dispute), they acquired rights to perform the service of extracting and delivering the coal and, presumably,[55] so long as they performed satisfactorily, to prevent production of the coal without their participation; but they did not acquire legal control of the coal deposit, which remained in Paragon.[56] Second, the operators did not have a fixed or determinable right to share in the value of the mineral deposit, so that their contract rights fell short of an ownership interest.[57] Third, insofar as amounts paid an operator came from coal, the source was all the coal mined from Paragon's leasehold, and not the coal he mined. No operator's return was dependent solely on extraction of the coal from the area in which he claimed an interest, and hence the claimed interest was not depletable.[58] These being the facts, it is apparent

[53] See *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362, 368; *Parsons* v. *Smith*, 359 U.S. 215, 225-226.

[54] *Ibid.*

[55] See footnote 5, *supra*.

[56] Part A, *supra*, pp. 14-17.

[57] Part B, *supra*, pp. 18-23.

[58] Part C, *supra*, pp. 23-26.

that the operators' investments were in their employment contracts, not in the coal in place.

CONCLUSION

The judgment of the Court of Appeals, permitting depletion deductions to the contract mine operators, should be reversed and remanded for entry of an order affirming the Tax Court.

Respectfully submitted,

JEWELL RIDGE COAL CORPORATION

By SEYMOUR S. MINTZ
ROBERT K. EIFLER
800 Colorado Building
Washington, D. C. 20005
Attorneys for Jewell Ridge Coal Corporation

HOGAN & HARTSON
800 Colorado Building
Washington, D. C. 20005
Of Counsel

January 1965.